Supreme Court, U.S.
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No. 00-205

IN THE

Supreme Court of the United States

RUTH E. JOHNSON, COMMISSIONER OF REVENUE, STATE OF TENNESSEE,

Petitioner,

v.

J.C. PENNEY NATIONAL BANK,

Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of Tennessee

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

May a State, contrary to this Court's definition of the "substantial nexus" requirement of the Commerce Clause in *National Bellas Hess, Inc. v. Department of Revenue* and *Quill Corporation v. North Dakota*, impose franchise and excise (net income) taxes on corporations that have established no direct or indirect physical presence in the taxing jurisdiction?

CORPORATE DISCLOSURE STATEMENT

Respondent J.C. Penney National Bank was a federally chartered national banking association incorporated under the laws of Delaware; it was dissolved on December 17, 1998. Prior to its dissolution, Respondent was a wholly owned subsidiary of J.C. Penney Company Inc., a publicly-held corporation. J.C. Penney Company will be responsible for paying the Petitioner's tax assessment if it is ultimately held to be valid. No parent or publicly held company owns 10% or more of J.C. Penney Company's stock.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent J.C. Penney National Bank ("JCPNB") requests that this Court deny the petition ("Pet.") for writ of certiorari filed by Ruth E. Johnson, Commissioner of Revenue, State of Tennessee (the "Commissioner"), seeking review of the decision of the Tennessee Court of Appeals entered in this case on December 17, 1999.

STATEMENT

In her petition, the Commissioner asks this Court to reconsider and overturn the bright-line standard that, for over thirty-five years, has marked the outer limit of a state's power to tax interstate commerce. In the decision below, Tennessee's intermediate appellate court applied well-established Commerce Clause principles, as most recently explained in *Quill Corp. v. Commissioner*, 504 U.S. 298 (1992), and held unconstitutional a tax levied against an out-of-state taxpayer that had no substantial nexus with Tennessee. The opinion is a well-reasoned, unexceptional application of this Court's precedents.

This Court repeatedly has held that states may constitutionally tax only those out-of-state businesses that have a "substantial nexus" with the state. An attempt to impose *any* tax upon an out-of-state business that lacks this "substantial nexus" unduly burdens interstate commerce in violation of the Commerce Clause. *See, e.g., Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 626 (1981); *Fulton Corp. v. Faulkner*, 516 U.S. 325, 334 (1996). This Court has twice expressly held that, to establish substantial nexus, an out-of-state business must have a physical presence in the taxing state. *National Bellas Hess, Inc. v. Department of Rev. of Illinois*, 386 U.S. 753 (1967); *Quill*, 504 U.S. at 298. While *Bellas Hess* and *Quill* both involved state sales and use taxes, *every* state tax that has withstood this Court's Commerce Clause scrutiny has involved

a taxpayer with a meaningful physical presence within the taxing state.

In her petition, the Commissioner characterizes the decision below as an aberration in the development of "contemporary commerce clause jurisprudence" (Pet. 13), and asks this Court to "reject such an unwarranted application of its precedents." (Pet. 11) Contrary to these claims, however, the decision below is an unremarkable application of the "substantial nexus" standard developed and applied by this Court in *Quill*, *Complete Auto*, and many other cases. Indeed, the court below noted that the Commissioner was "unable to provide any authority" supporting a departure from this Court's well-settled definition of "substantial nexus." (Pet. App. 18a-19a) Applying this Court's precedents, the court below held that Tennessee could not tax JCPNB solely because the bank had availed itself of economic markets in Tennessee exclusively through use of the U.S. mail. (Pet. App. 29a)

STATEMENT OF THE CASE

1. JCPNB'S Business In Tennessee.

In 1983, J.C. Penney Company acquired the Harrington National Bank and changed its name to J.C. Penney National Bank. (Pet. App. 3a & n.1) JCPNB was a federally chartered national banking association, was incorporated under the laws of Delaware, and was separately incorporated from the J.C. Penney Company. JCPNB's principal place of business and commercial domicile was Harrington, Delaware. (Pet. App. 3a-4a & n.2) JCPNB engaged primarily in credit card lending and consumer banking by issuing VISA and MasterCard credit cards and by offering banking services such as commercial and consumer loans and savings and checking accounts.[1] (Pet.

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[1] JCPNB's lending activities were limited to issuing "universal cards" such as VISA and MasterCard, which are accepted at world-wide business locations. These credit cards are separate from the J.C.

App. 3a-4a) JCPNB ceased its banking operations on December 17, 1997, sold all of its consumer banking and credit card business in a variety of transactions over the course of the following year, and dissolved on December 17, 1998.

Throughout its existence, JCPNB conducted all of its business activities from its Delaware offices; "[n]one of the[se] activities . . . occurred in the State of Tennessee." (Pet. App. 6a) JCPNB had "no offices or other places of business in Tennessee" and did not own or lease any tangible or intangible property in Tennessee. (*Id.*) A majority of the bank's directors, and all of its officers and employees, were located in Delaware. (*Id.*)

JCPNB "outsourced" much of the work associated with its credit-card business to other entities. In some cases, these entities were related to JCPNB (such as the J.C. Penney Company and Business Services, Inc.); in other cases they were not (such as MBNA and SSBA).[2] But in all cases, these entities operated entirely outside of Tennessee. (Pet. App. 4a-6a) The J.C. Penney Company retail stores in Tennessee performed no credit-card solicitation or processing services for or on behalf of JCPNB. In fact, consumers could neither apply for, nor make payment on, JCPNB's credit cards at the retail stores because either activity would have violated federal law. (Pet. App. 6a & n.6, 22a-23a)

Penney Company proprietary card, which is accepted exclusively at J.C. Penney Company retail stores. JCPNB had no role in J.C. Penney Company's proprietary card activities. Similarly, J.C. Penney Company's retail stores had no role in JCPNB's universal card activities. (Pet. App. 4a & n.2; *id.* at 6a)

[2] These related-party contracts were negotiated and performed at arm's length, as required by federal banking law. Pet. App. 5a n.3; *see also* Federal Reserve Act § 238, 12 U.S.C. § 371e-1.

2. Tennessee's Franchise and Excise Tax.

Tennessee imposes a franchise and excise tax on financial institutions "doing business" in Tennessee. Tenn. Code Ann. §§ 67-4-806, 67-4-903. A financial institution is deemed to be "doing business" in Tennessee if it "regularly solicits business from potential customers" in Tennessee or "regularly engages in transactions with customers in [Tennessee] that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within [Tennessee]." Tenn. Code Ann. §§ 67-4-806(d)(2), 67-4-903(f)(2). Tennessee enacted this financial institutions tax in 1990, seeking for the first time to tax out-of-state financial institutions that had no physical presence in the state, but that solicited business from Tennessee consumers through the U.S. mail. The Tennessee legislature simultaneously sought to tax the mail-order sales industry by passing an amendment purporting to subject out-of-state vendors who "regularly solicit" Tennessee consumers to state use taxes, even though mail-order companies had no physical presence in Tennessee and even though this Court had held in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that states could not extend the reach of their taxing powers so far. In *Bloomingdale's By Mail Ltd. v. Huddleston*, 848 S.W.2d 52 (Tenn. 1993), the Tennessee Supreme Court, consistent with this Court's *Quill* decision, held that the legislature had over-stepped its taxing authority.

JCPNB never filed an excise or franchise tax return with the Tennessee Department of Revenue (the "Department"), nor did it ever pay excise taxes to Tennessee. In fact, JCPNB never paid an excise or income tax to any state other than Delaware, and JCPNB's Delaware income tax liability was based upon 100% of its net income. (Pet. App. 8a)

The Department audited JCPNB for the period of February 1990 through January 1994. On November 1, 1995, the Department issued a $178,314 assessment to JCPNB,

which included $111,725 in franchise and excise taxes, $27,932 in penalties, and $38,657 in interest. The Department calculated the assessment by applying a single-factor, gross receipts apportionment formula applicable to financial institutions. Tenn. Code Ann. §§ 67-4-815, 67-4-919; Pet. App. 8a.[3]

3. The Proceedings Below.

In the trial court, the Chancellor concluded that JCPNB had established a "meaningful physical presence" in Tennessee, and thus had "substantial nexus," chiefly because some JCPNB-issued VISA and MasterCard credit cards were present in Tennessee, and because JCPNB's parent, the J.C. Penney Company, operated retail stores in Tennessee. (Pet. App. 40a-42a)

Tennessee's intermediate appellate court reversed. It concluded that this Court's physical-presence standard for "substantial nexus" could not be satisfied by the presence of the credit cards in Tennessee, because "the real asset is the intangible account which the card represents" and which was "located, for tax purposes, in the State of Delaware." (Pet. App. 22a) The court also rejected the Chancellor's holding that a substantial nexus existed based on "the activities of the

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[3] The standard apportionment formula applicable to out-of-state corporations doing business in Tennessee is a three-factor formula that compares the out-of-state corporation's property, payroll, and sales located or occurring in Tennessee to the out-of-state corporation's property, payroll, and sales located or occurring elsewhere. Tenn. Code Ann. §§ 67-4-811, 67-4-910. By contrast, financial institutions such as JCPNB are subject to a single-factor apportionment formula based exclusively on a comparison of the financial institution's gross receipts attributable to business activities conducted in Tennessee and the gross receipts attributable to all of its business activities conducted everywhere. Tenn. Code Ann. §§ 67-4-815, 67-4-919.

affiliates and third parties working on JCPNB's behalf" (Pet. App. 23a) because the activities on which the Chancellor had relied occurred entirely outside of Tennessee (Pet. App. 22a-23a). Furthermore, the court held that the J.C. Penney Company's Tennessee retail stores could not create a substantial nexus between JCPNB and Tennessee because the stores were unrelated to any aspect of JCPNB's business. (*Id.*) Instead, it held that an out-of-state bank that conducted a credit-card business with Tennessee cardholders exclusively through the U.S. mail lacked the "substantial nexus" that the Commerce Clause requires for a state to assert its taxing authority. (Pet. App. 26a) Accordingly, just as the Tennessee Supreme Court struck down Tennessee's unconstitutional mail-order tax in *Bloomingdale's By Mail*, the court below struck down this related attempt to tax out-of-state banks connected to Tennessee only by consumer solicitations through the U.S. mail.

The Tennessee Supreme Court declined the Commissioner's application for discretionary review without comment. (Pet. App. 29a)

REASONS FOR DENYING THE WRIT

I. THE TENNESSEE COURT OF APPEALS' DECISION WAS A ROUTINE APPLICATION OF THIS COURT'S PRECEDENTS THAT DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR OF A STATE COURT OF LAST RESORT

This is not an appropriate case for certiorari. The question before the Tennessee Court of Appeals was whether the Commerce Clause permits Tennessee to impose its franchise and excise tax on an out-of-state financial institution that conducted business with Tennessee residents exclusively through the U.S. mail and that had established no direct or indirect physical presence in Tennessee. The opinion below properly

considered and applied this Court's precedents to find that JCPNB had not established the "substantial nexus" required by the Commerce Clause and, thus, that Tennessee could not tax JCPNB. Accordingly, Petitioner presents no issue that warrants this Court's plenary review.

A. The Decision Below Was Factbound And Did Not Explicitly Apply a "Physical Presence" Rule

Tennessee's intermediate appellate court did not even decide the issue that the Commissioner has presented to this Court. A careful reading of the decision below indicates that the court did not explicitly adopt a "physical presence" test to determine whether Tennessee may impose franchise and excise taxes on an out-of-state business. The court below recognized that "[t]he analysis in this area is necessarily done on a case-by-case basis" and that "[t]here is no . . . specific point at which a substantial nexus exists." (Pet. App. 18a) Furthermore, it expressly disclaimed deciding whether "physical presence" was required, noting that "[it] is not our purpose to decide whether 'physical presence' is required under the Commerce Clause." (Pet. App. 25a) Instead, the court employed this Court's precedents—including, but by no means limited to, *Quill* and *Bellas Hess*—as guideposts to "delineate that level of 'presence' in the State of Tennessee that will justify the imposition of the types of taxes that are the subject of this appeal." (Pet. App. 18a) After considering all of the facts and circumstances in the record, the court concluded that JCPNB did not have a sufficient presence in—"nexus" to—Tennessee to be subjected to the franchise and excise tax.

Contrary to the Commissioner's assertion (Pet. 20), the court below did not, in making its factbound analysis, "unwittingly extend" *Quill's* physical-presence test to the franchise and excise taxes before it. The court merely considered and rejected (Pet. App. 11a-12a, 17a-18a) the Commissioner's attempt to create a novel constitutional test for substantial nexus that not only would have eliminated any

physical-presence requirement, but that also would have replaced the Court's "substantial nexus" Commerce Clause jurisprudence with the "purposeful availment" standard that defines Due Process Clause "minimum contacts," *see Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475 (1985). The Commissioner urged below, and argues anew here, that Tennessee should have the power to tax businesses that "purposefully avail themselves of the market within [Tennessee]" or that otherwise have "established continuing business relationships with customers in [Tennessee] through interstate commerce." (Pet. 27-28) As the court below noted, this test would "obliterate" (Pet. App. 18a) the "fundamental[ ]" line that *Quill* drew between Due Process "minimum contacts" and Commerce Clause "substantial nexus" (504 U.S. at 305, 313) and would subject JCPNB to tax in any state in which its account holders traveled and made credit-card purchases.[4]

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[4] Consider the case of a Tennessee resident who purchases a meal from a Chicago restaurant that deposits the credit card slip in its New York merchant bank. In turn, the New York bank submits the credit card slip to the Delaware bank that issued the credit card for payment. Under the Commissioner's test, each of Tennessee, Illinois, New York and Delaware would have the authority to tax the extension of credit—especially if the Delaware bank had other credit-card customers in each of the foregoing states. *See National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977) (holding that once the taxpayer establishes nexus with the taxing state, all of the taxpayer's activities related to that state are constitutionally taxable). Under the current physical-presence standard, only Delaware could tax the interest income earned by the Delaware bank from the credit card transaction (and, in fact, as noted above, Delaware has imposed such a tax on 100% of JCPNB's income). As Part II below discusses more fully, Congress is best qualified to weigh the myriad of policy issues associated with establishing a cohesive state-tax nexus regime.

Having rejected the Commissioner's attempt to rewrite this Court's precedents, the court below reached its conclusions without expressly adopting a "bright-line" physical-presence standard. Instead, the court held that, regardless of the exact level of "presence" required by the Commerce Clause, it "fail[ed] to see the substantial nexus necessary to sustain the tax." (Pet. App. 26a) Thus, the fact-intensive analysis that yielded the decision below falls well short of deciding the pure legal issue that the Commissioner has presented to this Court for review. Accordingly, this Court should deny the petition.

B. This Court Has Consistently Held That An Out-Of-State Taxpayer Must Have a Substantial Physical Presence Within the Taxing State to Establish a "Substantial Nexus"

Even if the decision below had required physical presence for "substantial nexus," such a holding would be entirely consistent with this Court's Commerce Clause jurisprudence. This Court has twice expressly held that "substantial nexus" requires physical presence, *National Bellas Hess*, 386 U.S. at 753; *Quill*, 504 U.S. at 298, and every case that has upheld nexus to tax has done so only where the taxpayer in fact had a physical presence in the taxing state.

Cases decided by this Court both before and after *Quill* have made clear that a substantial nexus is required for the imposition of *any* state tax on an out-of-state business. *See, e.g., Allied Signal, Inc. v. Director*, 504 U.S. 768, 778 (1992) ("The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation *at all*." (emphasis added)); *Commonwealth Edison Co.*, 453 U.S. at 626 ("Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it." (emphasis in original)). Indeed, *Quill* itself did not limit the physical-presence requirement to state sales and use taxes; it merely observed that "we have not, in our review of other types of taxes, articulated the same physical-presence

requirement that *Bellas Hess* established for sales and use taxes." 504 U.S. at 314.

The Commissioner has pointed to no Commerce Clause decision of this Court that has found "substantial nexus" in the absence of physical presence; indeed, in discussing the prior decisions of this Court that are alleged to conflict with the decision below, the Commissioner concedes that "there may have been some form of physical presence in these instances." (Pet. 19) We are certainly aware of no case upholding state-taxing nexus in the absence of physical presence, and commentators have opined that no such case exists:

> [In *Quill*], the Court nevertheless made it clear that the nexus required under the Commerce Clause is more than the minimum contacts/purposeful availment of a state's market that are sufficient to satisfy the modern Due Process Clause; and at least to this point, "substantial nexus" sufficient to satisfy the Commerce Clause has *always involved some degree of physical presence* with the state.

Constitutional Limitations on Jurisdiction to Tax and the Impact of Quill and Geoffrey, State Tax Notes, Aug. 7, 1995, at 423 (emphasis added).

Certainly, this Court has never suggested that the meaning of "substantial nexus" varies from one context to another, and it would be strange indeed to do so. This shifting standard would yield the bizarre result that a state could establish substantial nexus with an out-of-state taxpayer for one type of tax but not for another. On the contrary, this Court has not hesitated to apply "substantial nexus" principles derived in cases involving sales and use taxes to cases involving other types of state taxes. *See, e.g., Tyler Pipe Indus., Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232 (1987) (relying on *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)), which involved a state use tax, to analyze whether a taxpayer had a substantial nexus with a state that subjected it to a direct business tax).

Moreover, this Court has never intimated that *Quill*'s definition of "substantial nexus" applies only to sales and use taxes; indeed, this Court has characterized the constitutional question decided in *Quill* as "whether the state has the authority to tax the corporation *at all*." *Allied Signal*, 504 U.S. at 778 (emphasis added). This treatment is consistent with the Court's steadfast refusal to draw artificial distinctions among various types of state taxes, which could cause their validity to turn on "legal terminology" and "draftsmanship and phraseology." *See Complete Auto Transit*, 430 U.S. at 281.

The Commissioner's position also would yield the bizarre result that the Commerce Clause's substantial-nexus test imposes a rigorous physical-presence standard for a use-tax collection obligation—an obligation which merely imposes administrative burdens on the out-of-state company—but allows direct taxation of an out-of-state bank's net income and net worth (*and* imposes administrative costs on the taxpayer) under a much more relaxed and amorphous standard. Contrary to the Commissioner's submission, however, this Court has expressly refused to distinguish jurisdiction to tax from jurisdiction to compel collection of taxes as agent for the state. *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977); *see also Quill*, 504 U.S. at 319 (Scalia, J. concurring) ("As an original matter, it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, but we have rejected that.").

Although the court below pointed out that the "Commissioner [was] unable to provide any authority as to why the [substantial nexus] analysis should be different for franchise and excise taxes" (Pet. App. 19a), she attempts in her petition to make the case that direct income taxes are less burden-some than use-tax collection obligations (Pet. 15). Her attempt is far from compelling.

First, she does not account for the direct financial burdens that income taxes place on the taxpayer beyond the associated administrative costs. This Court itself has remarked that these direct burdens and their associated risk of unconstitutional multiple taxation make the case for striking down an income tax imposed upon an out-of-state business even stronger than the case for striking down the imposition of a mere use tax collection obligation. *See National Geographic Soc'y*, 430 U.S. at 557-58; *Standard Pressed Steel Co. v. Washington Rev. Dep't*, 419 U.S. 560 (1975).[5]

Second, notwithstanding her reliance upon the difference in the number of filing jurisdictions for sales and use taxes, and the relative administrative burdens associated with such taxes, the Commissioner developed no record that would support this "burden" argument below—an omission that would severely handicap plenary review—and her submission on this point is dubious in any event.[6]

Finally, the Commissioner has ignored the myriad of other compliance burdens that multistate businesses face when preparing and filing corporate net-worth and income-tax returns

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[5] Indeed, the Tennessee statute imposes precisely that risk of multiple taxation. JCPNB paid an income tax to the state of Delaware based on 100% of its net income, yet Tennessee does not even provide for a credit mechanism by which this multiple taxation burden may be alleviated. Tenn. Code Ann. § 67-4-808; Pet. App. 8a.

[6] The Commissioner ignores the fact that, although there may be filing requirements in 6,000-plus jurisdictions imposing sales and use taxes, the sales and use tax rules are generally uniform among the various filing jurisdictions in a given state. Thus, businesses must contend only with about 50 sets of rules for and exemptions to the use tax—approximately the same number of sets of rules for determining net worth and income taxes owed to the various states. (*See* Pet. at 15)

and paying the taxes shown thereon. The process of filing a state income-tax return is far more complicated and burdensome than simply applying a tax rate to the number shown as federal taxable income on the corporation's federal income-tax return. Indeed, a treatise cited by the Commissioner devotes approximately *800 pages* to the legal principles and compliance issues associated with state corporate income taxes. Hellerstein & Hellerstein, *State Taxation* (3d ed. 1998).[7] For

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[7] The following highlights only some of these numerous compliance issues:

First, there is the threshold issue of identifying the taxpaying unit. Affiliated groups filing consolidated income tax returns for federal purposes must determine, with respect to each state, which of their various member corporations are subject to tax in each state. Not only may the affiliates with direct jurisdictional nexus vary from state to state, but so also may the legal standards for determining both nexus and those group members that are engaged in a unitary business. *See generally* Hellerstein, *supra*, at 8-57 to 8-211. If a corporation is part of a "unitary business" with its affiliates, many states will include its income in the apportionable tax base for the unitary group. The petition may provide the best evidence of the convoluted analysis that every multistate business would have to perform when determining whether the "economic presence" of the business within the state is sufficient to subject it to a state's taxing jurisdiction. Even if the legal issues are clear, tax record keeping by the overall group may be complicated by the varying sets of in-state taxpayers. Moreover, if some affiliates are deemed outside the state's taxing jurisdiction, transactions between the inside and outside affiliates are subject to review under statutory provisions giving the revenue administrator the power to reallocate income among affiliated taxpayers if the administrator determines that the taxpayer is inappropriately shifting income to other states. *See, e.g.*, Tenn. Code Ann. § 67-4-804(c).

Second, once the precise taxpaying unit is identified, taxpayers must then determine the potential tax base that is within each state's

these reasons, if there were to be different standards for "substantial nexus" for different types of taxes, a taxpayer should have a *more* substantial connection to a state to be

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reach. States follow different income apportionment formulas—in some cases, for example, giving extra weight to the sales factor to a variety of degrees. *See generally* Hellerstein, *supra*, at 9-114 to 9-258. For example, New York double weights the sales factor for regular tax (but not for minimum tax) purposes; Illinois, Connecticut, Kentucky, Massachusetts, Ohio and Tennessee, among others, simply double-weight the sales factor; and Minnesota's three-factor formula is weighted 70-15-15 in favor of sales. Some states, including Tennessee, single out financial institutions for special apportionment formulas. *See generally id.* In Tennessee, a single factor sales formula is used for financial institutions. Tenn. Code Ann. § 67-4-815. Even where the formulas are facially the same, their precise meaning may differ from state to state. As an example, the includability, and if includable, the location, of intangible property and the income derived from such property under what appear to be identical formulas vary widely from state to state.

Third, income tax compliance involves applying the rules for determining taxable income once the potential tax base is known. Contrary to the Commissioner's argument, it is in the sales and use tax area where determination of the tax is simply a matter of multiplying gross receipts by the sales tax rate. States' rules for computing taxable income, however, vary from the federal rules and from each other in significant respects. For example, California and New York have their own depreciation systems for business property. All property subject to these systems therefore has a different basis and, as a result, a different amount of gain or loss upon disposition. Tennessee itself has modified federal depletion rules, federal charitable contribution rules, rules with respect to interest earned on certain municipal bonds, federal capital loss and net operating loss carry forwards, certain federal depreciation allowances related to leasing transactions, and federal accounting for bad debt reserves. *See* Tenn. Code Ann. § 67-4-805.

subject to an income tax because there is in that situation a higher potential to burden interstate commerce.

This Court has noted on several occasions that "our law in this area is something of a 'quagmire' and its 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the states in the exercise of their indispensable power of taxation." *Quill*, 504 U.S. at 315-16 (citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-458 (1959)). Indeed, *Quill* concluded that, despite some "artificial[ity] at its edges," the "bright-line [physical presence] rule . . . furthers the ends of the dormant Commerce Clause" by "firmly establish[ing] the boundaries of state authority" to tax and "reduc[ing] litigation concerning those taxes." 504 U.S. at 314-15. The benefits of certainty and predictability in the administration of state taxing statutes, and the resulting reduction in litigation, are at least as worthy of protection in the context of state franchise and excise taxes as in the context of state sales and use taxes. As further noted in *Quill*, this consistency "encourages settled expectations, and in doing so, fosters investment by businesses" such as JCPNB that are confronted with a plethora of state taxing schemes. *Id.* at 316.

By contrast, the Commissioner's "economic presence" test for state income and net worth taxes would result in different

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As further proof of the complexity of state franchise and excise tax issues, one need only compare the Tennessee sales and use tax return, which consists of two pages, with the Tennessee franchise and excise ("F&E") tax return, which consists of ten pages. Furthermore, financial institutions and their unitary affiliates must file a special Tennessee F&E Tax Return that similarly consists of ten pages. *See* Tennessee Dep't of Revenue Franchise and Excise Tax Forms (visited Aug. 31, 2000) <http://www.state.tn.us/revenue/forms/fae/index.htm>.

tests for the same "substantial nexus" standard—one applicable to sales and use taxes, another for state income and net worth taxes. This test would only further confuse this area of the law. The Commissioner's murky "I know nexus when I see it" standard would introduce significant uncertainty—and protracted litigation—into this otherwise well-settled area.

C. No Conflict Exists Among State Courts of Last Resort Regarding a State's Power to Subject an Out-of-State Taxpayer to a State Income Tax

Contrary to the Commissioner's claims, state courts have not, in the wake of *Quill*, "fallen into disarray" (Pet. at 21) concerning the proper standard for evaluating substantial nexus under the Commerce Clause in the context of other state taxes. Only two state courts of last resort—not, importantly, including the decision of Tennessee's intermediate appellate court below—have specifically addressed *Quill*'s application to other types of state taxes. These two decisions, by the Commissioner's own admission (Pet. App. 21a-22a), do not "conflict" with one another, so there is no conflict among state courts of last resort. *See* S. Ct. Rule 10(b). Moreover, the Commissioner's asserted "obviou[s] . . . direct conflict" (Pet. at 22) between those two decisions and the decision below dissolves upon examination.

The Commissioner relies (*id.*) on dicta from *Couchot v. State Lottery Commission*, 659 N.E.2d 1225 (Ohio 1996), in which the Supreme Court of Ohio mused that this Court had affirmatively limited the physical-presence substantial nexus standard to sales and use taxes. However, as the Ohio Supreme Court noted, the peculiar facts in that case *did* demonstrate physical presence: A Kentucky resident purchased a winning Ohio lottery ticket in Ohio. Not surprisingly, the court held that the Ohio lottery winnings were subject to Ohio income taxation: "Couchot played the Ohio lottery. He purchased his winning ticket in Ironton and redeemed it in Columbus. The entire income received by

Couchot . . . is directly related to his physical presence in Ohio." *Id.* at 1230. Thus, the taxpayer's physical presence in Ohio satisfied *Quill*'s standards. *Id.*[8]

In *Geoffrey, Inc. v. South Carolina Tax Commissioner*, 437 S.E.2d 13 (S.C. 1993), the South Carolina Supreme Court summarily concluded, in two brief paragraphs, that "[i]t is well settled that the taxpayer need not have a *tangible*, physical presence in a state for income to be taxable there. The *presence of intangible property* alone is sufficient to establish nexus." *Id.* at 18 (emphases added).[9] The South Carolina court thus relied upon a standard of "intangible" physical presence to force-fit its case within the "substantial nexus" standard of *Quill*; it concluded that the taxpayer had established a presence in South Carolina through its licensees' substantial use of a license and trademark within the state, which gave its property a business situs or "presence" in South Carolina sufficient to establish "substantial nexus." *Id.* at 16-17. But that holding does not conflict with the Tennessee

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[8] The Commissioner's characterization of the Illinois intermediate appellate court decision in *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), is similarly flawed. *Borden* involved an Illinois operating limited partnership and an out-of-state limited partner. Finding that the operating partnership was an "agent or conduit" through which the out-of-state limited partnership's income passed, the court concluded that the limited partnership had a physical presence in Illinois. *Id.* at 80.

[9] The authority on which the South Carolina Supreme Court relied for these supposedly "well-settled" principles was a dubious line of pre-*Quill* intermediate appellate court cases from New Mexico and this Court's decision in *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944). These pre-*Quill* cases, however, applied the minimal Due Process nexus standard and never considered the higher hurdle imposed by the Commerce Clause in light of the *Quill* principles discussed above.

courts' holdings below: Here, the trial court found that the "situs of JCPNB's intangible property is located in Delaware" (Pet. App. 41a), and the Commissioner did not challenge that finding on appeal. Thus, whatever flaws the *Geoffrey* opinion may have had, its "intangible physical presence" holding presents no conflict with the decision below.

Contrary to the Commissioner's view of this area of the law, the state courts have consistently held that some meaningful physical presence must be established by an out-of-state taxpayer to subject it to a state's taxing jurisdiction for income-based taxes as well as collection obligations. In addition to *Couchot* and *Geoffrey*, see *Cerro Copper Products, Inc. v. State of Alabama*, F. 94-444 (Admin. Law Div. 12/11/95) (Alabama franchise tax); *Magnetek Controls, Inc. v. Department of Treasury*, 562 N.W.2d 219 (1997) (Michigan single business tax); *Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349 (1993) (same); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000) (Texas franchise tax). Like the court below, none of these courts has distinguished sales and use taxes on the one hand, and other forms of state taxes on the other, in a way that would justify the radically different constitutional "substantial nexus" tests for each proposed by the Commissioner here.[10]

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[10] The Texas Court of Appeals in *Bandag* summed up the issue in words generally appropriate to this case:

> The term "substantial nexus" is a term of art. In the context of sales and use taxes, the Supreme Court has held that the term requires a physical presence in the taxing state when the vendor's only activity within the state is interstate communication with its customers via common carrier and the United State mail. *See Quill Corp.*, 504 U.S. at 311, *National Bellas Hess, Inc. v Department of Revenue*, 386 U.S. 753, 758, 87 S. Ct. 1389, 18 L. Ed. 2d 505 (1967). BLC is not physically present in Texas. The Comptroller argues, however, that *Quill Corp.* and *Bellas*

In sum, there is no conflict, and certainly no "disarray," among the lower courts that warrants certiorari review.

II. THERE IS NO OTHER COMPELLING BASIS FOR THIS COURT'S REVIEW

As shown in Part I above, the Commissioner has failed to demonstrate a conflict between this Court's prior decisions, prior state-court decisions, and the decision of the Tennessee

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Hess should be limited to the context of sales and use taxes and that the benefit BLC derives from its possession of a certificate of authority—the opportunity to do business in Texas under the state's protection regardless of whether it chooses to exercise that privilege—constitutes the necessary "substantial nexus." The Supreme Court, however, addressed the flaw in this argument by stating that "there is no economic consequence that follows necessarily from the use of the particular words 'privilege of doing business', and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect" under the Commerce Clause. *Complete Auto*, 430 U.S. at 288. Although written in the context of sales and use taxes, *Quill Corp.* and *Bellas Hess* do not purport to apply a standard other than the "substantial nexus" test applied in *Complete Auto* to a "privilege of doing business" tax in Mississippi.

Like BLC in the present case, the sole activity the foreign corporations in *Quill Corp.* and *Bellas Hess* conducted was by interstate commerce—communication by United States mail and common carriers. While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

18 S.W.3d at 299-300.

intermediate appellate court below. That should be enough to deny review. But there is an additional, and independent, reason that certiorari should not be granted here: This Court's intrusion would be particularly inappropriate at this time, when Congress is actively reviewing this area of state taxation of interstate commerce.

One of the fundamental reasons that this Court adopted and reaffirmed the bright-line physical-presence test in *Bellas Hess* and *Quill* was its recognition that "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve" because "Congress has the plenary power to regulate commerce among the states." *Quill*, 504 U.S. at 305. Indeed, in the years leading up to *Quill*, Congress had considered and consistently rejected legislation that would "overrule" *Bellas Hess*. *See id.* at 318. In *Quill*, this Court removed the Due Process Clause nexus impediment to state taxation (which could not have been altered by Congress), and left in place the Commerce Clause's "substantial nexus" requirement (which could be altered by Congress). By doing so, the *Quill* Court invited Congress to intervene, stating that "Congress is now free to decide whether, when and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes." *Id.*

In fact, since *Quill*, Congress has considered and debated numerous legislative proposals, which only underscores the fact that adjusting the allowable burdens on interstate commerce involves delicate policy decisions and coordinated efforts among interested parties that are far more suited to congressional, rather than judicial, action and that have an impact far beyond the mail-order use-tax-collection context.

The fact that those extensive efforts have not yet resulted in enacted law is understandable, however, since the *Quill* decision came just as the Internet, and "e-commerce," was emerging onto the national (and international) scene. This new

commercial medium has presented Congress with new and complex issues to consider in the context of state-taxation nexus, and Congress has approached that subject with appropriate care and deliberation. In fact, Congress has become so alarmed at state efforts to push the constitutional envelope and expand their taxing jurisdiction into this area that it has imposed a three-year moratorium on "Internet related" taxes, during which the Advisory Commission on Electronic Commerce ("ACEC") will study this and related issues and make its recommendations. *See* Internet Tax Freedom Act of 1998, Pub. L. No. 105-277. While the primary focus of that Act is the Internet, the ACEC was created to study a wide variety of tax issues, including, among other options, the adoption of a uniform nexus standard for *all* taxes (income taxes, as well as sales and use taxes). Accordingly, the appropriate boundaries of state taxing jurisdiction are receiving a significant amount of national attention and careful study in the political branches, with many of the leading proposals urging a single nexus standard for all taxes.[11]

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[11] *See, e.g., Proposal of Governor James S. Gilmore, III* (Document No. 107 of the E-Commerce Commission Document Library located at *www.ecommercecommission.org*, which would adopt a physical presence standard for income and for sales and use taxes); *Proposal of Dean Andal, Vice Chairman of the California State Board of Equalization* (Document No. 64, which suggests the adoption of a "substantial physical presence" nexus standard for all state and local taxes). For other examples of Congress' ongoing efforts in this area, see, *e.g.*, S.1825, 103d Cong. (1994) (authorizing collection of certain state and local taxes with respect to the sale, delivery, and use of tangible personal property); S.545, 104th Cong. (1995) (same); H.R. 3039, 104th Cong. (1996) (proposing a national sales tax to be administered primarily by the states); Internet Tax Freedom Act, S.442, 105th Cong. (1998) (to impose a moratorium on new, multiple, or discriminatory state taxes on the Internet); Internet Nondiscrimination Act of 2000, H.R.3079, S.2028, & S.2255, 106th Cong. (2000) (to extend the Internet Tax Freedom Act until

What all of this demonstrates is that any conceivable confusion regarding the Commerce Clause's "substantial nexus" standard can be, and is likely to be, resolved by Congress in the near term. This Court should not accept the Commissioner's invitation to insinuate itself into the middle of this national debate, for such judicial intervention would surely stall the ongoing legislative efforts to develop a national nexus standard for all types of taxes. "In this situation, it may be that 'the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.'" *Quill*, 504 U.S. at 318-19 (quoting *Commonwealth Edison Co.*, 453 U.S. at 637-38 (White, J. concurring)).

October 21, 2006); Internet Tax Reform and Reduction Act of 2000, H.R. 4267, 106th Cong. (2000) (to adopt certain recommendations of the ACEC); Internet Tax Simplification Act of 2000, H.R.4460, 106th Cong. (2000) (to adopt certain recommendations of the ACEC); New Economy Tax Simplification Act, S.2401, 106th Cong. (2000) (to adopt, based upon *Quill*, a uniform jurisdictional standard for nexus from Internet related business activities); Internet Tax Elimination Act, H.R.3252, 106th Cong. (2000) (to make the Internet a tax-free zone); Fair and Equitable Interstate Tax Compact Simplification Act of 2000, H.R.4462, 106th Cong. (2000) (to facilitate the states' creation of a streamlined sales tax collection system); Internet Tax Moratorium and Equity Act, S.2275, 106th Cong. (2000) (to extent the Internet Tax Freedom Act moratorium and promote the adoption of state sales tax simplification measures); *Interstate Use Tax Collection: Hearing Before the Senate Committee on Small Business*, 103d Cong. (1994); *Internet Taxation in the New Millenium: Hearing Before the Senate Budget Committee*, 106th Cong. (2000).

CONCLUSION

For these reasons, the Commissioner's petition for writ of certiorari should be denied.

Respectfully submitted,

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